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IN THE
Supreme Court of the United States
OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.,
Petitioner,

v.

UNITED STATES,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF OF DONREY, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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BRIEF OF DONREY, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

INTEREST OF THE *AMICUS CURIAE*

Donrey, Inc. ("Donrey"), directly or through subsidiaries, owns and operates newspapers located primarily in the central and western part of the United States. Donrey acquired most of the newspapers it now owns by purchasing them from their prior owners as ongoing businesses. One of the most valuable assets Donrey acquires when it purchases a newspaper is the "subscription list" or "paid subscribers" of the newspaper.[1] An opinion of

[1] The terms "subscription list" and "paid subscribers" have been used to describe the same asset. *Compare* the Third Circuit's opinion below, Pet. App. 1a-30a, *with Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987). Those terms are used interchangeably herein.

this Court determining whether, and under what circumstances, such subscription lists may be amortized could have a significant impact on Donrey's nationwide newspaper enterprises.

Donrey's 1972 acquisition of one newspaper, the Washington (Indiana) Times Herald, was the subject of the Eighth Circuit's opinion in *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987). In the *Donrey* case, the Eighth Circuit addressed the legal question at issue here: *i.e.*, whether a party that acquires a newspaper as a going concern and that values the acquired subscription list based upon the income that the subscription list may be expected to generate may amortize the subscription list over its useful life. The Eighth Circuit held that a taxpayer is entitled to a depreciation allowance for an intangible asset, such as a subscription list, if the taxpayer sustains its burden of proof under the two-pronged test enunciated in *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974) and endorsed by the Internal Revenue Service ("IRS") in Rev. Rul. 74-456, 1974-2 C.B. 65, and Rev. Rul. 76-520, 1976-2 C.B. 42. Under the *Houston Chronicle* test, the taxpayer must establish that the intangible asset (1) has an ascertainable value separate and distinct from goodwill; and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy. The Eighth Circuit in *Donrey* held that Donrey had met the *Houston Chronicle* test and was therefore entitled to amortize the subscription list. *Donrey*, 809 F.2d at 536-37.

Amicus believes that the Eighth Circuit's *Donrey* opinion—unlike the decision under review—reflects the proper legal approach to the question presented. Moreover, the *Donrey* decision is based upon an accurate understanding of the nature and function of a newspaper subscription list. The Eighth Circuit, unlike the Third Circuit, has acknowledged the critical fact that a newspaper subscription list is not simply, or even primarily, a list of customers who are expected to generate future subscription revenues. Rather, "the subscription list is an indispensable tool in selling advertising and is not simply a list but instead is used much as a machine to generate advertising revenue." *Id.* at 536.

Although the opinion below is ambiguous in a number of respects, it clearly goes beyond a decision that, in this particular case, the taxpayer failed to carry its burden of proof under the two-pronged *Houston Chronicle* test. Pet. App. 29a-30a. Instead, the Third Circuit apparently has held that subscription lists acquired in connection with the acquisition of ongoing newspaper businesses are not depreciable as a matter of law, at least if they are valued by reference to the income they are expected to generate. *Id.* (customer lists cannot be "valued as the stream of *income* to be generated by the listed customers over their remaining years of patronage" because such value "*inherently includes* much or all of the value of the expectancy that those customers will continue their patronage —*i.e.*, the goodwill of the acquired concern") (first emphasis in original).

In *amicus*' judgment, the Third Circuit's opinion adopts an erroneous rule of law, which rests, at least in part, upon the mistaken belief that newspaper subscription lists are simply customer lists that derive their value solely from the future subscription revenues which the listed customers are expected to provide. In view of the importance of this issue to Donrey and to the newspaper industry generally, Donrey is filing this brief as *amicus curiae* in support of petitioner in this case.[2]

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[2] Pursuant to Rule 37 of the Rules of this Court, the parties have consented to the filing of this brief. Letters of consent from the parties have been filed with the Clerk of this Court.

INTRODUCTION AND SUMMARY OF ARGUMENT

The court of appeals held that petitioner is not entitled to amortize the "paid subscribers" or "subscription lists" of the acquired newspapers despite the fact that petitioner "has demonstrated that the paid subscribers have an ascertainable value and limited useful lives, and that it has presented a reasonably accurate estimate of these useful lives." Pet. App. 9a.[3] The court of appeals thereby articulated a new rule of law: that an "income approach"[4] to valuing a subscription list acquired in connection with the purchase of an ongoing business produces a value for the list that, as a matter of law, is inherently inseparable from goodwill and may not be amortized. *Id.* at 30a.

The Third Circuit's decision below is based upon two fundamental errors. First, the decision cannot be reconciled with the plain meaning of Section 167(a) of the Internal Revenue Code (the "Code"). Second, the new legal rule adopted by the court rests upon a profound misunderstanding of the nature, function and value of a newspaper subscription list.

I.

Section 167(a) of the Internal Revenue Code, 26 U.S.C. § 167(a), provides in clear terms that a depreciation deduction "shall" be allowed for tangible and intangible wasting assets used in a trade or business.[5] Both the

[3] *See* Pet. App. at 28a-29a ("for tax purposes, there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable").

[4] In the opinion below, the Third Circuit refers to a method of valuing an asset that is based upon the income the asset is expected to generate as an "income approach", while it describes a valuation based upon the cost of reproducing the asset as a "cost approach." Pet. App. 29a.

[5] A "wasting" asset is one that, because of exhaustion, wear and tear or obsolescence, is established to be of use in the business or in the production of income for only a limited period, the duration of which may be estimated with reasonable accuracy. *G.W. Van Keppel Co.* v. *Commissioner*, 295 F.2d 767, 770 (8th Cir. 1961).

United States and the court below concede that petitioner has demonstrated that the paid subscribers of the acquired newspapers have an "ascertainable value and limited useful lives," which could be estimated with reasonable accuracy. Pet. App. 9a. The statute mandates a depreciation deduction under such circumstances, and the Third Circuit's decision denying amortization with respect to a concededly wasting asset runs directly counter to the plain meaning of the statute.

The court of appeals based its holding on a vague, general definition of a word, "goodwill," found nowhere in the statute. The term "goodwill" appears solely in one of the interpretive regulations issued by the Department of Treasury under Section 167(a). Treas. Reg. § 1.167(a)-3 (as amended in 1960) (hereinafter the "Treasury Regulation") ("No deduction for depreciation is allowable with respect to good will"). In its opinion, the Third Circuit decided that the label "goodwill" may be affixed to the paid subscribers acquired by petitioner notwithstanding the fact that petitioner is conceded to have established that the paid subscribers are valuable assets with limited useful lives of reasonably ascertainable duration. It thus construed the Treasury Regulation as denying depreciation for business assets which have been shown to meet all the requirements of Section 167(a). So interpreted, the Treasury Regulation is invalid. See *Northern Natural Gas Co.* v. *O'Malley*, 277 F.2d 128, 133-35 (8th Cir. 1960); *United States* v. *Vogel Fertilizer Co.*, 455 U.S. 16, 24-25 (1982).

The court of appeals' interpretation ignores the overriding mandate of Section 167(a) that a depreciation deduction "shall" be allowed with respect to a wasting asset. In contrast, an approach to defining goodwill that

is faithful to the statutory command should ask whether "the reasons for denying amortization deductions for goodwill are fully applicable." See *Houston Chronicle*, 481 F.2d at 1247-48. The regulation's injunction that no depreciation deduction shall be allowed for goodwill simply reflects the fact that—by definition—"goodwill" is not a wasting asset. Indeed, the most salient characteristic of goodwill is that it is self-regenerating and has an *indefinite* useful life; it is an ongoing asset that fluctuates but does not necessarily diminish. See *id.*

Under this analysis, "[t]he most significant indication that an intangible asset is separate and apart from goodwill is whether its useful life can be shown with reasonable accuracy to be of limited duration. The most important criterion is whether in fact it is a wasting asest." *Richard S. Miller & Sons, Inc.* v. *United States*, 537 F.2d 446, 452, 454 (Ct. Cl. 1976) (per curiam). See *Colorado Nat'l Bankshares, Inc.* v. *Commissioner*, T.C.M. (P-H) ¶ 90,495, at 2397 (1990). An approach that focuses on the command of the controlling statute—and that interprets the Treasury Regulation in a manner consistent with that command—leads to the inescapable conclusion that a subscription list purchased in the acquisition of a newspaper should, upon the necessary factual showing, be treated as an amortizable asset.

II.

Aside from the error inherent in the Third Circuit's definition of "goodwill," the decision below also rests on a fundamentally flawed assumption regarding the character and value of a subscription list in the newspaper industry. The court of appeals' conclusion that, as a matter of law, a valuation of a subscription list, based on an "income approach," is necessarily inseparable from goodwill rests upon the court's factual assumptions that a subscription list is simply a "customer list" and that

an "income approach" to valuing such a list must solely reflect the expectation of continued patronage by the listed customers. Pet. App. 29a-30a. In this case, it does appear that petitioner's experts derived the value of each subscription list by determining the present value of the subscription revenues that the listed subscribers were expected to produce over the useful life of the list. *Id.* at 6a.

However, this focus on the income stream generated by future subscription revenues is not the only, or even the most appropriate, means of valuing a subscription list. In *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987), for example, the evidence clearly showed that newspapers receive 80 percent of their revenue from advertisers, not subscribers. Advertisers are, however, willing to pay a premium to advertise in a newspaper that has paid subscribers, as distinguished from a "shopper" which is distributed free of charge, because they know that people who have a paid subscription to a newspaper are more likely to read it. A subscription list is therefore "an indispensable tool in selling advertising and is not simply a list but instead is used much as a machine to generate advertising revenue." *Id.* at 536. The Eighth Circuit observed that: "One of Donrey's experts testified that the value of the subscription list is related to this revenue enhancement—it is the present value of the difference in advertising revenues generated by the subscription list as compared to the revenues of an equivalent paper without a subscription list. *This value was thus characterized as being separate and apart from goodwill.*" *Id.* at 536 (emphasis added).

Donrey's evidence as to the business function and value of a newspaper subscription list is surely an "income approach," albeit one quite different from the "income approach" considered by the Third Circuit in this case. Yet, an "income approach" properly may be used to value any business asset because all business assets de-

rive their utility from the income they are expected to produce. See, *e.g.*, *Protective Comm.* v. *Anderson*, 390 U.S. 414, 442 (1968). As the Eighth Circuit understood in *Donrey*, newspaper subscription lists, like other business assets but unlike goodwill, have a "measureable value for a specific use": namely as a tool for generating additional advertising income. See *Citizens & S. Corp.* v. *Commissioner*, 91 T.C. 463, 516 (1988) (Cohen, J., concurring), *aff'd*, 919 F.2d 1492 (11th Cir. 1990) (per curiam). This "measurable value," as well as their limited life, distinguishes them from goodwill.

ARGUMENT

THE COURT OF APPEALS ERRED IN HOLDING THAT NEWSPAPER SUBSCRIPTION LISTS WITH ASCERTAINABLE VALUES AND LIMITED USEFUL LIVES, THE DURATION OF WHICH HAS BEEN ESTIMATED WITH REASONABLE ACCURACY, MAY NOT BE DEPRECIATED AS A MATTER OF LAW.

In applying a definition of a nonstatutory term, "goodwill," to hold that newspaper subscription lists are not depreciable even though they are conceded to be valuable wasting assets with determinable useful lives, the Third Circuit strayed far afield from the congressional mandate laid down in Section 167(a) of the Internal Revenue Code. The decision below should therefore be reversed as inconsistent with the statute. However, even if the Court were to conclude that petitioner failed to prove that the subscription lists it acquired were depreciable assets, the Third Circuit's apparent conclusion that newspaper subscription lists are, as a matter of law, inseparable from goodwill when valued using an "income approach" is clearly incorrect and rests upon a fundamental misconception of the character, function and value of paid subscribers in the newspaper industry. Accordingly, any decision affirming the judgment of the court of appeals should be limited to the particular facts of this case.

A. The Third Circuit's Decision That A Valuable Wasting Asset May Not Be Depreciated Is Fundamentally Inconsistent With Section 167(a) Of The Internal Revenue Code.

The Third Circuit based its holding on a vague, general definition of the term "goodwill"—a term used in Treasury Regulation Section 1.167(a)-3, but not found in Section 167(a).[6] In the Third Circuit's view, the district court reached the wrong result not because of any specific flaw in its application of the statutory requirements to the facts at hand, but because it "applied the wrong definition of 'goodwill.'" *Id.* at 29a. *Amicus* submits that the Third Circuit's conclusion—that a concededly valuable wasting asset is nondepreciable—is contrary to the clear language of Section 167(a) of the Internal Revenue Code.

In language that has changed little since the Revenue Act of 1913, Section 167(a) of the Code provides for the depreciation of wasting assets:

> There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.

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[6] Treas. Reg. § 1.167(a)-3 provides in pertinent part as follows:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. *No deduction for depreciation is allowable with respect to good will.*

Treas. Reg. § 1.167(a)-3 (as amended in 1960) (emphasis added).

26 U.S.C. § 167(a). See Revenue Act of 1913, Ch. 16, § II B, 38 Stat. 167; 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 23.1.1 (2d ed. 1989). The allowance for depreciation flows from the fundamental nature of our income tax: it is a tax on *net* income. Taxpayers are allowed to deduct from gross income the cost of producing that income. See 26 U.S.C. §§ 63, 161, 162 *et seq.*

One of the costs of producing income is the cost of wasting assets whose value is exhausted over the course of their useful lives. *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 101 (1943). "[I]t is the primary purpose of depreciation accounting to further the integrity of periodic income statements by making a meaningful allocation of the cost entailed in the use . . . of the asset to the periods to which it contributes." *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 104 (1960); *Northern Natural Gas Co.* v. *United States*, 470 F.2d 1107, 1109 (8th Cir.), *cert. denied*, 412 U.S. 939 (1973). Furthermore, Section 167(a) "does not distinguish between tangible and intangible assets and it says nothing by way of disqualifying an asset for depreciation merely because it is an intangible." *Northern Natural Gas Co.* v. *O'Malley*, 277 F.2d 128, 139 (8th Cir. 1960) (Blackmun, J., concurring). See Treas. Reg. § 1.167(a)-3 (as amended in 1960); *Griswold* v. *Commissioner*, 400 F.2d 427, 433 (5th Cir. 1968).

By the express terms of Section 167(a), a finding that the value of an asset will be exhausted over a useful life of reasonably ascertainable duration entitles the taxpayer to depreciation. See *Northern Natural Gas Co.*, 277 F.2d at 131; *Super Food Servs., Inc.* v. *United States*, 416 F.2d 1236, 1238 (7th Cir. 1969). Thus, in *Northern Natural Gas*, the Eighth Circuit relied upon Congress' use of the word "shall" in Section 167(a)'s predecessor:

> It is our belief that the statute authorizing the deduction is mandatory and not permissive, and requires the Commissioner to grant the deduction to a taxpayer who brings his claim within the provision of the statute.

Northern Natural Gas Co. v. *O'Malley*, 277 F.2d at 131-32.

The Third Circuit's conclusion that the "wasting asset" in question is not depreciable rests, not upon any analysis of the statutory language, but upon what the court believed to be the "proper definition of goodwill." Pet. App. 29a-30a. Although Congress never has declared that a wasting asset is not depreciable if it may be characterized as "goodwill," the concept of "goodwill" was introduced in an interpretive regulation—Treas. Reg. § 1.167(a)-3—issued by the Department of Treasury under Section 167(a). After providing that a depreciation deduction is allowed for intangible assets that are "of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy," the Treasury Regulation then declares that "[n]o deduction for depreciation is allowable with respect to good will." Treas. Reg. § 1.167(a)-3 (as amended in 1960); see *supra* p. 9 n.6.

Section 1.167(a)-3 was promulgated pursuant to the Treasury Department's general authority under Section 7805(a) of the Code to "prescribe all needful rules and regulations." Section 7805(a) is not a grant of substantive rulemaking authority or "a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision." *United States* v. *Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982) (quoting *Rowan Cos.* v. *United States*, 452 U.S. 247, 253 (1981)). As an "interpretive" regulation, Section 1.167(a)-3 cannot establish more stringent conditions for depreciation of intangible assets than those imposed by the clear language of the statute. See *Northern Natural Gas Co.* v. *O'Malley*, 277 F.2d at 133-35.[7] It cannot take away a right clearly

[7] In *Northern Natural Gas*, the Eighth Circuit was addressing the counterpart to Treas. Reg. § 1.167(a)-3 under the Internal

granted by the statute; nor can it restrict or enlarge the scope of the statute. *Id.* at 134 ("[i]n interpreting a regulation, courts will ordinarily avoid a construction which raises doubt as to the validity of the regulation").[8]

The primary flaw in the decision below is that the court's interpretation of the term "goodwill," as used in the Treasury Regulation, is contrary to the mandate of Section 167(a). In essence, the Third Circuit has held that the proper scope of the regulatory term "goodwill" includes the "paid subscribers" acquired by petitioner even though, as valuable assets with limited useful lives of reasonably ascertainable duration, the "paid subscribers" unquestionably satisfy the statutory requirements for depreciability. Thus, assets that are *conceded* to have "wasting lives that can be estimated with reasonable accuracy," Pet. App. 29a, are deemed not to be depreciable for the sole reason that, in the Third Circuit's view, they come within the injunction—found in the Treasury Regulation but not in the statute—that "[n]o deduction for depreciation is allowable with respect to good will." *Id.* at 8a-9a. The Third Circuit's interpretation of the Treasury Regulation constitutes "an attempted addition to the statute of something which is not there," and therefore is invalid. See *United States* v. *Calamaro*, 354 U.S. 351, 358-59 (1957); *Vogel Fertilizer Co.*, 455 U.S. at 24-25; *Northern Natural Gas* v. *O'Malley*, 277 F.2d at 133-35. See also *INS* v. *Cardoza-Fonseca*, 480 U.S. 421, 446-448 (1987). This interpretation of the Treasury Regulation is neither necessary nor appropriate.

Revenue Code of 1939. The statute and regulation considered in *Northern Natural Gas* are substantially identical to their modern counterparts, now before this Court.

[8] *See also Steen* v. *Commissioner*, 508 F.2d 268, 270 (5th Cir. 1975) (per curiam) (also construing regulations under Section 167(a)); *Bhada* v. *Commissioner*, 89 T.C. 959, 972 (1987), *aff'd*, 892 F.2d 39 (6th Cir. 1989); *Graves* v. *Commissioner*, 88 T.C. 28, 33 (1987); *Apis Prods., Inc.* v. *Commissioner*, 86 T.C. 1192, 1205 (1986).

In determining what is goodwill, the analysis must instead be guided by the overarching mandate of Section 167(a) that a depreciation deduction "shall" be allowed with respect to a wasting asset. The interpretation of "goodwill" that is more faithful to the statute reflects the reason why goodwill is not depreciable. Thus, in *Houston Chronicle*, the Fifth Circuit stated that, in ascertaining whether an intangible asset is amortizable:

> [t]he precise issue is often whether or not the asset involved is either ordinary goodwill or so much like goodwill that the reasons for denying amortization deductions for goodwill are fully applicable. Foremost among those reasons is the conclusive presumption that goodwill is a nondepreciating capital asset. Viewed in a business context, the economic value of a taxpayer's continuing goodwill within his field of operations is seen as an ongoing asset that fluctuates but does not necessarily diminish. The crucial question becomes one of asking whether the intangible capital asset involved necessarily possesses similar characteristics.

Houston Chronicle, 481 F.2d 1240, 1247-48 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974) (citations and footnote omitted). See also *Richard S. Miller & Sons, Inc.* v. *United States*, 537 F.2d 446, 454 (Ct. Cl. 1976) (per curiam) ("An intangible asset is separate and distinct from goodwill when its useful life can be shown with reasonable accuracy to be of limited duration."); *Colorado Nat'l Bankshares, Inc.* v. *Commissioner*, T.C.M. (P-H) ¶ 90,495, at 2397 (1990) ("[W]here the useful life of an intangible is shown to be limited, depreciation is available even though for some purposes it is an element of goodwill.").[9]

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[9] In the opinion below, the Third Circuit acknowledged the "analytical force" of the Tax Court's reasoning in *Colorado National*. Pet. App. 28a.

Properly understood, Treas. Reg. § 1.167(a)-3 interprets and applies the statute; it does not attempt to change it. Intangible assets that have limited useful lives are depreciable; depreciation is denied for assets with respect to which a limited useful life cannot be estimated with reasonable accuracy. Goodwill is not subject to depreciation because, by definition, it has an indefinite life and is self-regenerating. Accordingly, "[t]he most significant indication that an intangible asset is separate and distinct from goodwill is whether its useful life can be shown with reasonable accuracy to be of limited duration. The most important criterion is whether in fact it is a wasting asset." *Richard S. Miller & Sons, Inc.*, 537 F.2d at 452.

This understanding of the Treasury Regulation is consistent with its history. The sentence dealing with goodwill was added to the Treasury Regulation in substantially its current form in 1927. The Treasury Decision that amended the Treasury Regulation to add the sentence explained that the action was being taken "[i]n view of" the decision of the court of appeals in *Red Wing Malting Co.* v. *Willcuts*, 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927). T.D. 4055, VI-2 C.B. 63 (1927). In that case, the Eighth Circuit held that goodwill was not property for which a deduction could be claimed under the predecessor to Section 167(a) because "[w]e are satisfied that there can be no wear or tear of good will, or exhaustion thereof by use, and . . . [the statute] limits the allowance for obsolescence to such property as is susceptible to exhaustion, wear, and tear by use in the business, and good will is not such property." *Red Wing Malting*, 15 F.2d at 633. It is thus clear that "goodwill," as viewed by the court in *Red Wing Malting* and as then incorporated into the Treasury Regulation, is an asset that by definition has an indefinite life and is not subject to wear and tear. It must follow that, if a valuable intangible asset has been proved to have a limited useful

life—to be wasting—it is not "goodwill" as that term is used in Treas. Reg. § 1.167(a)-3.[10]

In sum, Section 167(a) provides that wasting assets are depreciable. All agree, as the district court found, that the subscription lists acquired by petitioner are wasting assets. That should end the matter. The judgment of the court of appeals should be reversed.

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[10] In its brief in response to the petition for a writ of certiorari in this case, the Government points out that the sentence of the Treasury Regulation dealing with goodwill "has been carried forward essentially unchanged through repeated reenactments of the revenue laws and has now 'acquired the force of law' . . . ." (Resp. 9) (quoting *Cammarano* v. *United States*, 358 U.S. 498, 508-11 (1959)). But the sentence by itself, and as interpreted by the courts in *Houston Chronicle* and the cases following it, is unexceptionable. It is only the unique gloss placed on "goodwill" by the court of appeals in this case that creates any problem. Certainly Congress has not ratified the Third Circuit's analysis.

In any event, there is no basis for reading the Treasury Regulation in a manner inconsistent with the governing statute. *Cottage Sav. Ass'n* v. *Commissioner*, 111 S. Ct. 1503, 1509 (1991); *Public Employees Retirement Sys.* v. *Betts*, 492 U.S. 158, 171 (1989). The Treasury Regulation, including the injunction against depreciating goodwill, was promulgated to interpret a statute that, since 1913, has unambiguously mandated that a depreciation deduction "shall" be allowed for wasting assets. The Treasury Regulation must be read, today as in 1927, in a manner consistent with that statute. See *INS* v. *Cardoza-Fonseca*, 480 U.S. 421, 446-48 (1987); *NLRB* v. *United Food & Commercial Workers Union, Local 23*, 484 U.S. 112, 123 (1987); *Securities Indus. Ass'n* v. *Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 137, 143 (1984). An interpretation of the Treasury Regulation which would deny depreciation with respect to a concededly wasting asset is manifestly inconsistent with Section 167(a) and, as discussed above, is neither necessary nor appropriate.

B. The Third Circuit Misunderstood The Nature And Function Of A Newspaper Subscription List And Erred In Determining That, As A Matter Of Law, The Income Approach To Valuing A Subscription List Fails To Produce A Value Separate And Apart From Goodwill.

Houston Chronicle and the cases following it have stated that the depreciability of an intangible asset is a question of fact and that a taxpayer is entitled to depreciate such an asset if he demonstrates that the asset has an ascertainable value separate and distinct from goodwill and a limited useful life, the duration of which can be estimated with reasonable accuracy. *Houston Chronicle*, 481 F.2d at 1251. See, *e.g.*, *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987) (newspaper subscription list); *Citizens & S. Corp.* v. *Commissioner*, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990) (bank "deposit base") (per curiam); *Richard S. Miller & Sons, Inc.*, 537 F.2d 446 (insurance "expirations").[11]

The opinion below recognized that petitioner established that the acquired subscription lists have limited useful lives, the length of which can be estimated with reasonable accuracy, and ascertainable value. Pet. App. 9a. The court held, however, that the method used by petitioner to establish the value of the subscription lists failed, as a matter of law, to distinguish them from goodwill. As recounted by the Third Circuit, petitioner's experts valued the subscription lists by reference solely to the anticipated future stream of subscription revenue. Specifically, the expert witnesses first calculated the present value of the gross subscription revenue stream that would be generated by the subscribers over their estimated useful lives.

[11] The IRS itself has ruled that the purchaser of a publishing corporation may depreciate the acquired subscription contracts provided that the purchaser establishes that they have an ascertainable value separate and distinct from goodwill and a limited useful life, the duration of which can be ascertained with reasonable accuracy. Rev. Rul. 76-520, 1976-2 C.B. 42.

They then subtracted the projected cost of collecting that subscription revenue. Pet. App. 6a.

In the view of the Third Circuit, petitioner's experts had treated each subscription list as a customer list "to be valued as the stream of *income* to be generated by the listed customers over their remaining years of patronage." Pet. App. 29a. The court concluded, apparently as a matter of law, that "when employed in the context of the sale of an ongoing concern, the income approach to valuing a list of customers inherently includes much or all of the value of the expectancy that those customers will continue their patronage—*i.e.*, the goodwill of the acquired concern."[12] Pet. App. 30a.

For the reasons set forth earlier, *amicus* believes that the Third Circuit's approach to goodwill is fundamentally flawed. However, even if the evidence introduced by petitioner was not adequate to satisfy petitioner's burden of proving a value for the subscription lists separate and apart from goodwill, it would not follow that an income

[12] The Third Circuit discussed three cases as "demonstrat[ing] convincingly" that the rule it articulates is correct. Pet. App. 23a-26a. Those cases are *General Television, Inc.* v. *United States*, 449 F. Supp. 609 (D. Minn. 1977), *aff'd*, 598 F.2d 1148 (8th Cir. 1979) (per curiam); *Panichi* v. *United States*, 834 F.2d 300 (2d Cir. 1987) and *AmSouth Bancorporation* v. *United States*, 681 F. Supp. 698 (N.D. Ala. 1988). The Third Circuit acknowledged, however, "that the validity of *AmSouth* is questionable after the Eleventh Circuit's decision in *Citizens & Southern* . . . ." Pet. App. 27a. In *Donrey*, the Eighth Circuit stated authoritatively that *General Television* does not stand for the rule of law endorsed by the Third Circuit. *See Donrey, Inc.* v. *United States*, 809 F.2d 534, 537 (8th Cir. 1987). Finally, in *Panichi*, the Second Circuit affirmed the District Court's judgment that a purchased customer list, which had been valued at a multiple of monthly receipts from the customers on the list, could be amortized over a 15 year life. *Panichi*, 834 F.2d at 301. While the case did not involve the purchase of an entire business, it is clear that the customer list was valued based on the expected continuing patronage of the listed customers over the useful life of the list.

approach to valuation is incompatible with amortization as a matter of law.

In the *Donrey* case, an "income approach" was also used to value the acquired subscription list, but it differed substantially from the "income approach" considered by the Third Circuit. The extensive evidence Donrey introduced regarding the nature, function and use of the acquired subscription list led the Eighth Circuit to reach the following conclusions:

> There was evidence that 80% of the newspaper's gross revenues come from advertising, without which the newspaper would not be profitable. The advertising rates are determined by the number of persons on the subscription list. . . . . Advertisers use the list in order to evaluate how many persons will see their advertisements. Many of the nation's newspapers have their lists independently audited by the Audit Bureau of Circulation so that advertisers will have confidence in their accuracy.

Donrey, Inc., 809 F.2d at 535-36.

Based upon this evidence of the nature and use of a subscription list, the *Donrey* court found that Donrey was able to establish a value for the list as a *distinct* income-generating asset:

> There was testimony that a newspaper with a subscription list is substantially different from the 'shopper' type paper which is distributed free of charge. Advertisers are willing to pay more to place advertisements in newspapers with paid subscription lists than in shoppers because readers are more likely to read newspapers for which they have paid. There was also testimony that the *Times Herald* derived *additional revenue from advertisers as a result of the subscription list.* One of Donrey's experts testified that the value of the subscription list is related to this revenue enhancement—it is the present value of the difference in advertising revenues generated by the subscription list as compared to the revenues of an equivalent paper without a subscription list.

Donrey, Inc., 809 F.2d at 536 (emphasis added). The value of a subscription list as "an indispensable tool in selling advertising" was thus "characterized as being separate and apart from goodwill." *Id.* at 536.

The evidence before the Eighth Circuit showed that newspapers do, of course, receive revenue directly from subscribers, and subscription lists properly derive a portion of their value from anticipated subscription revenues. However, Donrey demonstrated that a newspaper subscription list is not primarily a list of customers and its value is not primarily related to the stream of future subscription revenues it represents. Instead, a newspaper's principal "customers" are its advertisers, not its subscribers. Because advertisers are willing to pay a premium to advertise in a newspaper that has paid subscribers, a newspaper subscription list has distinct importance as a "machine to generate advertising revenue," *i.e.*, a revenue-generating asset that has an ascertainable value and limited useful life.[13] *Donrey, Inc.*, 809 F.2d at 536.

Amicus is concerned that, although the evidence in *Donrey* regarding the nature and value of the acquired subscription list differed substantially from that considered by the court of appeals in this case,[14] the Third Cir-

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[13] The importance of this asset is reflected in the fact that newspapers have their subscription lists audited by an independent agency, the Audit Bureau of Circulation, so that advertisers will have confidence in the accuracy of the lists. *Donrey, Inc.*, 809 F.2d at 536.

[14] The eight newspapers involved in the instant case also derived "upwards of 80 percent of their total revenues from advertising fees." Pet. App. 6a n.2. Although the "preferred" valuation method used by petitioner's experts was based solely on expected subscription revenues, one of the experts confirmed the results of this "preferred" valuation by performing an alternative analysis based

cuit would appear to treat both as "income approaches" in the context of the acquisition of an ongoing concern and therefore to deny depreciation as a matter of law.[15] Moreover, the Third Circuit's limited view of the nature and function of subscription lists, based solely on the facts of this case, obviously contributed to its conclusion that an income approach to valuation of any subscription list inevitably will include goodwill.

The *Donrey* decision itself provides ample evidence that the Third Circuit has painted with an overly-broad brush. Moreover, the Third Circuit's rejection of an "income approach" to valuation of this particular asset overlooks the fact that such an approach may be used to value *any* business asset because all business assets derive their utility from the income they are expected to produce for the business over their useful lives. See S. Reed, *The Art of M & A* 64 (1989); R. Brealey & S. Myers, *Principles of Corporate Finance* chs. 2-6 (1984). As this Court has observed on a number of occasions, "the commercial value of property consists in the expectation of income from it . . . ." *Galveston, H. & S. A. Ry.* v. *State of Texas*, 210 U.S. 217, 226 (1908); *Protective Comm.* v. *Anderson*, 390 U.S. 414, 442 (1968). That income results from the patronage—and hopefully repeat patronage—of customers. Hence, the value of all business assets ultimately reflects "the probability that old customers will resort to the old place." Yet, it surely does not follow that all assets are goodwill and not depreciable.

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on "all revenues and costs." Pet. App. 46a. See Pet. App. 6a-7a n.2, 44a-45a. However, the Third Circuit clearly did not understand from that testimony or other evidence that subscription lists have a function and value in the newspaper business distinct from "customer lists."

[15] The Third Circuit rather clearly treats its decision as in conflict with *Donrey*, although it does not say so explicitly. (Pet. App. 19a).

This point was made forcefully by Judge Cohen in her concurring opinion in the *Citizens and Southern* case:

> I have found . . . no authority for the proposition that assets, intangible or tangible, are not separate and distinct from goodwill unless no part of their value is related to continued patronage of customers of an ongoing business. . . . [A]ssets are frequently found to be eligible for amortization even though the price paid took into account the probable continuance of terminable business relationships. Tangible property, such as special purpose equipment, is unquestionably subject to depreciation even though its value may be enhanced by its use in an ongoing business. It seems to me that the requirement that an asset be separate and distinct *means only that it must have a measurable value for a specific use.*

Citizens & S. Corp. v. *Commissioner*, 91 T.C. 463, 515-16 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990) (per curiam) (citations omitted) (emphasis added). Based on the evidence introduced by Donrey, the Eighth Circuit understood that a newspaper subscription list has "a measurable value for a specific use": namely as a tool for generating additional advertising revenue. Numerous other courts have reached similar conclusions with respect to similar intangible assets.[16]

These cases confirm that the determination of whether an asset is depreciable—*i.e.*, whether the two prongs of the *Houston Chronicle* test are satisfied—is inherently factual. The Third Circuit's attempt to formulate a rule

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[16] *See, e.g., Commissioner* v. *Seaboard Fin. Co.*, 367 F.2d 646, 651 (9th Cir. 1966); *IT & S of Iowa, Inc.* v. *Commissioner*, 97 Tax Ct. Rep. (CCH) No. 34 at 4556-57 (1991); *Los Angeles Cent. Animal Hosp., Inc.* v. *Commissioner*, 68 T.C. 269, 274 (1977), *acq.*, 1978-2 C.B. 2; *Computing & Software, Inc.* v. *Commissioner*, 64 T.C. 223, 225, 232-37 (1975), *acq.*, 1976-2 C.B. 1; *Manhattan Co.* v. *Commissioner*, 50 T.C. 78, 91, 93 (1968), *acq.*, 1974-2 C.B. 3; *Business Servs. Indus.* v. *Commissioner*, T.C.M. (P-H) ¶ 86,086, at 338 (1986).

that income-based valuations of newspaper subscription lists are, as a matter of law, inherently inseparable from goodwill should be rejected.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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